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Nos. 00-511, 00-555, 00-587, 00-590, 00-602

IN THE

Supreme Court of the United States

VERIZON COMMUNICATIONS INC., *et al.*,
Petitioners,

v.

FEDERAL COMMUNICATIONS COMMISSION AND THE UNITED STATES OF AMERICA,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

RESPONDENT'S BRIEF OF AT&T CORP.

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QUESTION PRESENTED

1. Whether the court of appeals erred in holding that neither the Takings Clause nor the Telecommunications Act of 1996 requires incorporation of an incumbent local exchange carrier's "historical" costs into the rates that it may charge new entrants for access to its network elements?

LIST OF PARTIES AND AFFILIATES

The parties to the proceedings in the Eighth Circuit are listed in Appendix A and Appendix D of AT&T's Petition for Certiorari at 1a and 222a-224a.

Pursuant to Supreme Court Rule 29.6, respondent states as follows: AT&T provides telecommunications, cable, and other services. AT&T has no parent company. No publicly held company owns more than 10 percent of AT&T's stock.

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STATEMENT OF THE CASE

AT&T's Petitioner's Brief demonstrated that the Eighth Circuit erred by vacating the FCC's TELRIC regulation insofar as it requires that interconnection and network element rates be based on the costs of efficiently replacing the relevant facilities of the incumbent local exchange carrier ("LEC"). This holding, among other errors, is inconsistent with the Eighth Circuit's correct conclusion that the terms and "stated purposes" of the Telecommunications Act of 1996 are best promoted by a forward-looking incremental cost method. The Eighth Circuit's holding would require either a forward-looking method that is less favorable to LECs than TELRIC or the reproduction cost method that long has been uniformly condemned as irrational and as the worst of all possibilities.

Because the Eighth Circuit's holding is so plainly untenable, the incumbent LECs separately petitioned for review and claimed that the Eighth Circuit was wrong in upholding the use of any forward-looking cost method. They contend that it is plain from the Act's terms and from the context in which it was enacted that Congress required interconnection and network element rates to be based on the "historical costs" that are recorded in the LECs' books. They further claim that any other construction of the Act would present serious issues under the Takings Clause and that the FCC's rejection of historical cost was arbitrary and capricious.

As explained in detail below, these contentions are baseless. They are squarely foreclosed by the Act's terms. Moreover, they rest on the notion that the FCC was required to repudiate the economic and regulatory principles that provided the background for the 1996 Act. At that time, the FCC (and virtually all states) had determined that historical-cost ratemaking could not foster efficiency and had abandoned it even for the purpose of setting the LECs'

maximum earnings and revenues from their overall regulated services. Still more pertinently, the FCC and states had held that historical costs were irrelevant to competitive markets, and where competition had been authorized with other LEC services, they had required that LECs provide access to the essential facilities that they control under forward-looking cost standards. The LECs' Brief does not even acknowledge these facts. Instead, it attempts to divert the Court's attention from them by making a series of extrarecord assertions about the effects of the FCC's TELRIC rules that are out of order, unsupported by any competent evidence or findings, and demonstrably false.

AT&T's Petitioner's Brief provided a full statement of background to the FCC's adoption of TELRIC. But to place the LECs' claims in context requires some additional discussion.

1. In the past, the FCC and individual states would periodically conduct "rate cases" to determine the overall revenue requirements and earnings that incumbent LECs would be allowed in the respective interstate or intrastate jurisdictions. These determinations were based on estimates of the LECs' overall "costs of service." While there are different cost of service methods, each uses a formula in which total annual revenues were to be the sum of the LECs' (1) reasonable operating expenses, (2) depreciation (that is, the loss in value of investment in the LECs' plant during the year), and (3) a reasonable return on the LECs' net investment (sometimes called the "rate base"). The second and third prongs of this formula required a determination of the value of the LECs' total investment.

While regulatory authorities would regulate a utility's overall revenues and earnings under these standards, they generally did not make cost of service determinations for individual services during the time in which LECs had monopolies over all the telecommunications services and equipment used in their franchised territories. Rather, the

overall revenue requirements were allocated among individual services to promote various social objectives and to reflect the "value of service." Charges for basic residential local service were set at relatively low levels and charges for residential long distance service, business services, and other services were set at higher levels.

2. To determine the depreciation and return on investment components of revenue requirements, regulators must first determine the value of the LECs' overall investment. Prior to 1944, this determination was made under a "fair value" method in which regulatory bodies were required to consider a host of factors such as the original cost of the property, the cost of replacing the functions that make it valuable, and the cost of reproducing the precise equipment that the LEC was then using. *Smyth* v. *Ames*, 169 U.S. 466, 547 (1898). To implement "fair value" ratemaking, courts increasingly required determinations of the costs of reproducing the LECs' existing facilities "brick by brick." 1 A. Kahn, *The Economics of Regulation* 37-38, 112-13 (1988).

In 1944, this Court held that fair value ratemaking is no longer constitutionally required. *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602-05 (1944). The FCC and most states then generally began to set rates under a method that is variously referred to as "original cost," "historical cost," "embedded cost" or "prudent investment." Under this method, the current value of the LECs' investment is the amount of the historical book investments of the LEC, minus investments that were found imprudent at the time they were made, minus prudent investments that were found not to be currently "used and useful" in the provision of the regulated service, and minus accumulated depreciation.

3. Beginning in the 1980s, the FCC and virtually all state commissions determined that it was not in the public interest to continue to attempt to regulate the overall revenues and earnings of LECs under such "backward-looking" historical prudent-investment methods. They determined that this

method could not be administered in ways that would foster efficiency and prevent LECs from earning excessive monopoly profits.

For example, the FCC determined that historical-cost regulation gave LECs no "incentive . . . to control expenses" and that, under many conditions, it actually created positive incentives for them to "gold plate" their networks, to install capacity far in excess of that currently required to provide regulated services, and otherwise "to adopt inefficient, capital intensive approaches to business operations." *Rates for Dominant Carriers*, 5 FCC Rcd. 6786, 6790 (¶ 29 n.30) (1990). The reason was that, absent determinations of imprudence, the LECs' regulated rates would allow them to recover and earn a full economic return on whatever amounts were invested. *Id.* ¶ 29 & n.30 (citing authorities). Further, to the extent that excess capacity was installed to allow LECs to provide future regulated or unregulated services that face competition, today's monopoly ratepayers would subsidize the LECs' future competitive operations. *Separation of Costs of Regulated Tel. Serv. From Costs of Nonregulated Activities*, 2 FCC Rcd. 1298, 1301 (¶ 16) (1987).

And the FCC found that regulatory bodies could not "administer" a prudent-investment methodology in ways that would either "counteract these incentives" or otherwise foster efficiency, for a number of independent reasons. *Rates for Dominant Carriers*, 4 FCC Rcd. 2873, 2890 (¶ 31) (1989). First, it stated that regulators could never be assured of "obtaining accurate cost information as the carrier itself is the source of nearly all information about its costs." *Id.* Second, it concluded that even if it obtained accurate historical-cost information, it did not have the "the resources to review in detail the thousands of individual business judgments a carrier makes before" making any investment. *Id.* at 2890 (¶ 31). Third, the FCC found that even if there were the "vast increase[s] in [its] resources . . . required" to conduct these after-the-fact retrospective reviews, it "could not hope to

secure the kind of information that would permit [it] to second-guess a carrier's managers." *Id.* at 2909 (¶ 78). Finally, the FCC concluded that even "if [it] were to try to make these type of judgments, it would be very difficult to enforce them." *Id.*

The FCC and virtually all states thus decided to abandon historical cost of service regulation. Instead, they adopted "price caps" or other forms of "incentive" regulation that partially sever the link between a LEC's costs and its earnings. These systems make no judgment that LECs' existing rates reflect the efficient costs of service. Rather, they seek to assure only that future regulation does not introduce any greater inefficiencies. They thus "cap" a LEC's existing prices at their current levels, and require future annual reductions in the overall rates by percentages that are intended to represent the LEC's expected attainable increases in productivity, adjusted for inflation. Conversely, future increases are permitted if the rate of inflation exceeds the presumed percentage increase in the LEC's productivity.

Price cap regulations take away the LECs' prior right to recover all their historical prudent investment. In particular, under the FCC's price cap rules, a LEC will not recover the FCC's authorized rate-of-return (11.25%[1]) on its prudent historical investment if it fails to achieve the presumed levels of efficiency and productivity. But price cap regulations do not completely sever the link between a LEC's book "costs" and prices. The FCC regulations continue to require LECs to account for costs and to calculate rates of return, and these calculated rates of return can have consequences for the LECs' earnings. For example, until recently, FCC regulations required LECs to "share" with ratepayers returns above certain levels. See *Bell Atl. Tel. Cos.* v. *FCC*, 79 F.3d 1195, 1199 (D.C. Cir. 1996). In addition, if calculated rates of

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[1] *Represcribing the Authorized Rate of Return for Interstate Servs. of Local Exchange Carriers*, 5 FCC Rcd. 7507 (1990).

return fall below certain levels (today 10.25%), LECs are entitled to rate increases. *Rates for Dominant Carriers*, 5 FCC Rcd. at 6802 (¶ 127). Most fundamentally, the FCC periodically reexamines its regulations or resets the productivity offsets, and the calculated rates of return are used in these proceedings.

For these reasons, while price caps do not guarantee recovery of prudent investment, they also do not eliminate LECs' incentives to include inappropriate investments in their ratemaking books.[2] Indeed, it recently came to light that these books contain many entries for equipment that either was never installed or has been discarded. See *Continuing Prop. Records Audit*, 14 FCC Rcd. 7019, 7019 (¶ 1) (1999).

4. At the same time, while regulatory authorities abandoned direct regulation of the overall regulated earnings of LECs, they continued to exercise jurisdiction to determine appropriate prices of individual LEC services or products. This was necessary because competition had been authorized with a number of LEC retail services in the intervening years, and while LEC competitors could themselves provide some of the components of these services, they had to obtain other essential inputs from the incumbent LECs. The LECs' control over these essential inputs gave them the ability to prevent competition through one of two related methods that effect price-cost squeezes and give the LECs the ability to charge prices that their competitors cannot match. First, the LECs could misallocate the costs of competitive retail services to their monopoly operations, recover them from captive ratepayers, and thereby use monopoly revenues to

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[2] Both AT&T's and the LECs' economic experts have acknowledged this point. *See, e.g.*, AT&T's Opposition to the Four RBOCs' Motion to Vacate the Decree, William Baumol Aff. at 31, *United States* v. *Western Elec. Co.*, No. 82-0192 (D.D.C. filed Dec. 7, 1994); Motion of Bell Atlantic Corp., BellSouth Corp., NYNEX Corp., and Southwestern Bell Corp. to Vacate the Decree, David Sappington Aff. at 11, *United States* v. *Western Elec. Co.*, No. 82-0192 (D.D.C. filed July 6, 1994).

subsidize below-cost retail prices that their competitors could not match. Second, the LECs could charge their competitors prices for access to their essential facilities that exceed the economic costs which the LECs incur when they use those same facilities to provide competing services.

To prevent such anticompetitive pricing, states and the FCC almost uniformly held that the LECs' historical "sunk" costs were irrelevant, and they generally regulated the relevant LEC rates under a long run incremental cost method that is called "Total Service Long Run Incremental Cost" or "TSLRIC." See AT&T Pet'rs' Br. 6-12. It is based on the full economic cost of replacing the LECs' facilities with the most efficient generally available alternatives.

5. To foster local competition, the 1996 Act requires that LECs provide competitors with interconnections and access to network element at rates that are based on the "cost" of "providing" them. In the FCC rulemaking proceeding, the LECs' economic experts acknowledged that the efficiency objectives of the Act would be best met by basing these rates on long run incremental cost and by allowing LECs to recover investments in any currently underdepreciated assets either through rates for other services or through explicit subsidy payments.[3] Further, the record evidence demonstrated in detail that, in addition to the other factors that made use of historical cost inappropriate, the method would be difficult to administer in ways that would insure that LECs and their competitors incurred the same costs in using essential LEC facilities. See, *e.g.*, AT&T Reply Comments (May 30, 1996), W. Baumol et al. Reply Aff. at 5-7 & n.5 (JA 146-48).

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[3] *See* Bell Atlantic Comments (May 16, 1996), Robert Crandall Decl. at 6 (JA 84-85); *see also id.*, Jerry Hausman Aff. at 2-3 (JA 89-92); GTE Comments (May 16, 1996), Edward Beauvis Aff. at 2-4, (JA 103-07); US WEST Comments (May 16, 1996), Robert Harris and Dennis Yao Report at 5 (JA 136-38); Bell Atlantic Reply Comments (May 30, 1996), Alfred Kahn and Timothy J. Tardiff Decl. at 8 (JA 160-62).

As economic experts explained to the FCC, under a historical-cost method LECs would have the incentive and the ability to misallocate retailing and other costs to network elements, to artificially raise their competitors' costs, and to require their competitors' customers to pay twice for retail functions and for facilities that the competitors were themselves providing. A historical-cost method would further require tribunals to attempt to allocate statewide costs among areas having different population densities and to exclude the cost of facilities not needed to meet existing demand for regulated telecommunications services. The experts explained that all of these problems would be avoided by a "bottoms up" TSLRIC method that determined the costs that are today required to be incurred to install and operate properly sized facilities. See, *e.g.*, AT&T Comments (May 16, 1996), W. Baumol et al. Aff. at 3-13 (JA 60-73); W. Baumol et al. Reply Aff. at 1-7 & n.5 (JA 140-48).

The FCC adopted a TSLRIC method to govern the setting of rates for interconnections and network elements. However, the FCC called the method Total Element Long Run Incremental Cost or "TELRIC" because it would primarily be applied to determine the cost of providing network elements, not the cost of services. AT&T Pet'rs' Br. 17-19.

6. The record before the Court contains no evidence of what the LEC interconnection and network element rates would be under either a historical-cost method or TELRIC. The LECs' Petitioners' Brief has nonetheless sought to color the proceedings in this Court by relying on a series of unadjudicated and self-serving extrarecord assertions. LEC Br. 10, 31, 40.

For example, the LECs repeatedly claim that TELRIC produces rates that are "50% below historical cost." *Id.* Their principal contention is that an FCC model shows that the TELRIC of the total national LEC networks is $180 billion, but that the amount that the LECs "actually invested" is $342 billion. *Id.* at 10-11 & nn.6-7.

But the statistics on which the LECs rely provide no support for their claim. Preliminarily, the FCC model in question is used to determine the cost of providing "universal" basic telephone service. It thus does not cost all the facilities that LECs make available as network elements (which include facilities used to offer specialized and advanced telecommunications services), but only the facilities required to provide basic service. The FCC has thus found that universal service cost calculations cannot be presumed to reflect the appropriate level of network element rates under TELRIC.[4]

More fundamentally, the $342 billion to which the LECs refer is derived from a table that tracks their *gross* capital investment.[5] But for purposes of comparison with TELRIC's valuation of LEC networks, the more relevant figure is *net* depreciated historical investment, which reflects the estimated losses in value in their equipment due to the development of lower cost substitutes and to wear and tear. This represents the current value of the LEC networks under an historical-cost ratemaking method. According to the LECs' same statistical source, the incumbent LECs' net investment is about $166 billion.[6] TELRIC thus calculates a significantly higher current value to the LECs network – $180 billion plus the value of facilities excluded from the universal service cost calculations – than does a historical-cost method ($166

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[4] *Application by Bell Atl. New York for Authorization Under Section 271 of the Communications Act*, 15 FCC Rcd. 3953, 4087 (¶ 245) (1999), *aff'd*, 220 F.3d 607, 619-20 (D.C. Cir. 2000); *Joint Application by SBC Communications Inc., S.W. Bell Tel. Co. for Provision of In-Region InterLATA Servs. in Kan. & Okl.*, No. 00-217, 2001 WL 55637, ¶ 84 (FCC Jan. 22, 2001).

[5] LEC Br. 11 n.6 (citing Federal Communications Comm'n, *1999 Statistics of Communications Common Carriers* tbl. 2.7, at 32 (Aug. 11, 2000)).

[6] Federal Communications Comm'n, *1999 Statistics of Communications Common Carriers* tbl. 2.9, at 50 (Aug. 11, 2000).

billion). While these two figures are not perfectly comparable, they foreclose any claim that TELRIC necessarily produces dramatically lower valuations, much less valuations 50%-60% lower than historical cost.

The only other sources the LECs cite for the claimed 50% difference are assertions in their own affidavits and hearing exhibits. LEC Br. 10 nn.4 & 5, 14 n.10. But those assertions have not been credited or adopted by any court or agency, and they do not remotely establish the proposition the LECs urge upon this Court.[7]

The LECs also contend that TELRIC produces "radically discounted" prices which will inevitably induce massive inefficient entry by competitors, that those competitors will be able to seize substantial market share by targeting and winning business customers that are particularly profitable to serve, and that the LECs will unfairly be left predominantly with residential customers who are falsely asserted to be unprofitable to serve.[8] *Id.* at 5, 13-14. The LECs attempt to

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[7] For example, the LECs cite their November, 1996 testimony before a state commission for the proposition that "[w]hen state utility commissions began applying TELRIC, they typically produced discounts of 50% below historical cost." LEC Br. 10. That claim is facially false because no state commission had applied TELRIC at that time (three months after TELRIC's adoption), and the testimony merely compared two sets of proposed rates in one state. The LECs also cite LEC testimony in New York for the proposition that the historical monthly cost "for a copper loop" is $33.20 while the TELRIC price "for a loop" is $14.52 (*id.* at 14) – an apple-to-oranges comparison, because the TELRIC price to which they refer was calculated solely for fiber loops, which the New York commission concluded were less costly than copper loops. And the remaining unadjudicated assertions that the LECs cite relate to the separate FCC "'proxy prices'" which were not even derived through TELRIC and which are not before this Court. *Id.* at 10 & n.4; Pet. App. 18a-21a.

[8] As LECs have elsewhere demonstrated, their provision of residential local telephone service generally is profitable for them on a stand-alone basis. That is so even where LECs set retail rates for "basic telephone service" to "residential and rural customers . . . below cost" (LEC Br. 4),

support these claims with citations to a handful of newspaper articles and analyst reports from 1996 and 1997. *Id.* at 13 n.9.

But TELRIC has been in effect for nearly five years,[9] and none of these consequences has remotely occurred. To the contrary, most prices approved by regulators as TELRIC-compliant have proven too high to support competitive entry. In that regard, the Vice-Chairman of the lead Petitioner (Verizon) has publicly stated that local competitors who lease its network elements in New York cannot profitably compete with it at current prices,[10] and AT&T has shown that the same circumstances are likewise present elsewhere in the country.[11]

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for they more than make up the difference from the access charges they collect from long distance carriers for every call placed or received by a residential customer, from the charges for residential customers' intrastate toll calls, from the charges for "vertical features" like Call Waiting and Caller ID, from the "subscriber line charges" that appear on every customer's bill, and from the explicit universal service subsidy payments that the LECs receive for serving particular residential customers. *See, e.g.*, Direct Testimony of Frank Hatzenbuehler, U S WEST Communications, Inc., *The Investigation and Suspension of Tariff Sheets Filed by U S WEST Communications*, No. 96S-331T (Colo. Pub. Utils. Comm'n Dec. 13, 1996).

[9] Although the Eighth Circuit initially stayed the FCC's rules on jurisdictional grounds, the States announced that they would continue to apply TELRIC anyway. *See* AT&T Pet'rs' Br. 21 & n.23.

[10] He has stated that "leasing [Bell Atlantic's network elements] costs AT&T $22 per residential customer per month," so "'[w]hoever is buying (AT&T's) $24.95 product (its basic local service package) knows they're not making any money on it.'" R. Krause, *Verizon's New York Fight Key to AT&T Challenge*, Investors' Bus. Daily, Aug. 15, 2000, at A6 (quoting Ivan Seidenberg). As he recognized, new entrants incur a host of substantial start-up, operating and marketing costs beyond the cost of leasing network elements, so inflated rates deny competitors the "margins" they need to offer local residential service profitably. *Id.*

[11] *See, e.g.*, Comments of AT&T Corp. in Opposition to SBC Communication Inc.'s Section 271 Joint Application for Kansas and Oklahoma, Michael Lieberman Decl., CC Docket No. 00-217 (Nov. 15, 2000); Reply Comments of AT&T Corp. in Opposition to Verizon New

As a consequence, the more recent newspaper articles and analyst reports state that the competitive LEC industry now stands on the verge of collapse. "[I]nvestors [have] los[t] confidence in the fundamentals of the CLEC business model," M. Farrell, *ICG Tanks, Depressing Other CLECs*, Multichannel News, Oct. 2, 2000, at Finance 48. "[T]here has been 'carnage' among CLEC stocks," J. Mulqueen, *ICG Hit Hard by Revenue Shortfall, Resignations*, Interactive Week, Oct. 8, 2000, and numerous competitive LECs have filed for bankruptcy.[12] At the same time, incumbent LECs continue to add more access lines and their profits are soaring,[13] and "with their seemingly impenetrable local-service fortresses, are emerging as the hands-down winners."[14] These reports thus state that the immediate

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England Inc.'s Section 271 Application for Massachusetts at 24, CC Docket No. 00-176 (Nov. 2, 2000).

[12] *FBN Telecom Year In Review - 2*, Federal Filings Newswire, Jan. 2, 2001; S. Levine et al., *2001: We Make Eight Predictions for the Year in Telecom*, America's Network, Jan. 1, 2001, at 40; R. Fisher, *From the Desk of . . . Robert Fisher*, Comm. Today, Dec. 22, 2000; P. Sherer, *Deals & Deal Makers: Too Much Telecom*, Wall Street J., Aug. 15, 2000, at C1; J. St. Onge, *A Bankruptcy Boom Is Starting To Have Ripple Effects*, Dow Jones News Service, Oct. 5, 2000.

[13] *See* BellSouth Corp. 10-K, at 34-36 (filed Mar. 2, 2001) (reporting over $500 million growth in local services revenues to over $11 billion and access line growth of approximately 400,000 lines); SBC Communications Inc. 10-K, at 143 (filed Mar. 12, 2001) (reporting local service revenues increasing by 13.2% to over $22 billion and strong access line growth); Qwest Communications Int'l Inc. 10-K, Ex. 13, at F1-F4 (filed Mar. 16, 2001) (reporting increased local voice revenues and addition of over 340,000 access lines); Verizon Communications Inc. 10-K405, at F7-F8 (filed Mar. 23, 2001) (reporting over $700 millior growth in local services revenues to over $21 billion driven by increased usage of local network facilities).

[14] R. Farzad, *Has the Telecom War Been Won?*, Dow Jones News Service, May 15, 2001; S. Schiesel, *Sitting Pretty: How Baby Bells May Conquer Their World*, N.Y. Times, Apr. 22, 2001, at Money & Business 1.

"'prospects for local competition look abysmal'" because "'[i]n most of the country, it is just not happening.'"[15]

In short, to say the least, the Court should not assume the truth of the LECs' extrarecord assertion that TELRIC produces rates that have caused significant competitive losses for the LECs and that will leave them serving predominantly "below-cost" customers. And the LECs' tactics underscore the wisdom of this Court's refraining from constitutional judgments regarding claims of confiscation until it has before it real numbers that have been subject to the adversarial process and scrutinized by regulatory agencies and the lower courts.

SUMMARY OF ARGUMENT

There is no merit to the LECs' claim that the FCC acted unlawfully by refusing to require use of historical-cost methods to set rates for interconnection and network elements. The LECs' statutory claims are foreclosed by the Act's terms, its context, and its purposes – all of which demonstrate that, if anything, Congress intended to prohibit the use of historical-cost ratemaking. And there is no substance to the LECs' claim that the statute has to be construed to require a historical-cost method to prevent takings or that it was arbitrary and capricious for the FCC to reject this method.

1. By requiring that rates be based on "cost," 47 U.S.C. § 252(d)(1)(A), Congress did not mandate that interconnection and network element rates be set based on the historical costs recorded in the LECs' ratemaking books. Even when the term "cost" is used in isolation, the LECs' dictionaries and this Court's decisions establish that the term

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[15] *See* S. Schiesel, *For Most Local Phone Users, Choice Is Not Yet an Option*, N.Y. Times, Nov. 21, 2000, at C1 (quoting B. Adamik, President, The Yankee Group).

can mean either original cost or efficient replacement cost. *National Ass'n of Greeting Card Publishers* v. *United States Postal Serv.*, 462 U.S. 810, 831-32 (1983); *Black's Law Dictionary* 349 (7th ed. 1999).

Here, the textual context squarely forecloses the LECs' claim that "cost" must (or even can) mean the amount that was originally expended for an element, recorded in the LECs' ratemaking books, and purportedly determined to be prudent in prior rate-of-return ratemaking proceedings. Section 252(d)(1)(A)(i) requires that the rates be "based on the cost (determined *without reference* to a rate-of-return or other rate-based proceeding) of *providing* the interconnection or network element." 47 U.S.C. § 252(d)(1)(A)(i) (emphases added). The LECs' are seeking to rewrite the statute so that it requires that rates be based on the "cost [determined *with reference* to a rate-of-return or other rate-based proceeding] of *purchasing* the element". This claim is peculiarly spurious, for when the Communications Act requires determinations based on "original cost," it says so expressly. *Id.* § 213.

The LECs are also wrong in claiming that original cost ratemaking is required by the historical "context" of the 1996 Act. Congress enacted the 1996 Act long after the FCC and many state commissions had abandoned historical-cost ratemaking on the ground that it fostered inefficiency and could not be administered to prevent LECs from earning excessive profits from their overall regulated operations. More pertinently, it was then black letter law that historical costs are irrelevant to competitive markets, and the FCC and states had long used TSLRIC and other forward-looking methods where, as here, the question was the rates that LECs should be permitted to charge competitors for access to essential facilities.

Further, the Act requires not only that network element rates be based on cost, 47 U.S.C. § 252(d)(1)(A)(i), but also that they be "nondiscriminatory," *id.* § 252(d)(1)(A)(ii). The FCC's unchallenged findings establish that TELRIC

represents the costs that LECs incur in using the elements and that to base rates on historical cost would violate the ban on discrimination. In all events, even if the Act does not require forward-looking methods, it at least gives the FCC "broad methodological leeway" to determine interconnection and network element rates under forward-looking methods. *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. 366, 423 (1999) (Breyer, J., concurring in part and dissenting in part).

2. The LECs alternatively claim that § 252(d)(1) must be construed to require historical-cost ratemaking to avoid "serious" issues under the Takings Clause. In their view, the rejection of historical cost and the adoption of a forward-looking method raises "substantial arguments" that an uncompensated taking will "necessarily" result. *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128 n.5 (1985). This contention is baseless.

First, the adoption of TELRIC could not itself present a risk of a taking even if it were certain that LECs will hereafter be able to prove that network element rates have denied them recovery of historical costs that they have a right to recover. The Order provides that LECs may then petition the FCC for the right to recover the shortfall in other rates that are within the FCC's jurisdiction. This remedy bars any claim that the adoption of TELRIC will necessarily result in a taking. *Id.*; *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 391-92 (1978); *B&O R.R.* v. *United States*, 345 U.S. 146, 148 (1953).

Second, under this Court's holdings, a ratemaking body's decision to adopt historical cost, replacement cost, or some hybrid method to value a utility's investment itself raises no constitutional issue under the Takings Clause. See *Duquense Light Co.* v. *Barasch*, 488 U.S. 299, 310 (1989). There cannot be a substantial takings issue until a rate order is entered whose "total effect" could be said to deny the utility the opportunity to earn a return on investment that reflects the risks of operating under the agency's ratemaking methodology. *Id.* Here, moreover, TELRIC expressly requires that

LECs receive a full risk-adjusted return, so it facially mandates precisely what the Takings Clause requires.

The LECs also rely on the Court's statement that it would raise "serious constitutional questions" if agencies were "to arbitrarily switch back and forth between [ratemaking] methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." *Id.* at 315. But TELRIC does not represent even a one-time "switch" in ratemaking methodologies, much less an arbitrary switching back and forth that could have such consequences. The TELRIC regulation has no effect on the ratemaking methods that apply to the LECs' interstate and intrastate telephone services. It governs only the new wholesale arrangements that the 1996 Act requires LECs to provide for the first time in order to foster competition. Moreover, by adopting a forward-looking method for this purpose, the FCC followed its own prior decisions.

3. The FCC's rejection of historical-cost ratemaking was not arbitrary and capricious. The FCC had previously found historical-cost ratemaking could not promote efficiency in regulating the LECs' regulated businesses as a whole, much less prevent the LECs from misusing their control over monopoly facilities to impede competition with their own local services. More fundamentally, there was abundant evidence before the FCC – which was overwhelmingly supported by the experience and findings of state, federal, and foreign regulatory tribunals and the LECs' own submissions in other fora – that a forward-looking cost method could be more readily and reliably administered to promote the procompetitive objects of the 1996 Act.

ARGUMENT

I. SECTION 252(d)(1)(A) DOES NOT REQUIRE A HISTORICAL-COST RATEMAKING METHOD.

Section 252(d)(1) adopts three requirements that govern the setting of "just and reasonable rates" for interconnections and network elements. 47 U.S.C. § 252(d)(1)(A). First, the rates must be "based on the cost (determined without reference to a rate-of-return or rate-based proceeding) of providing the interconnection or network element." *Id.* § 252(d)(1)(A)(i). Second, they "may include a reasonable profit." *Id.* § 252(d)(1)(B). Third, the rates must be "nondiscriminatory." *Id.* § 252(d)(1)(A)(ii).

In the LECs' view, these terms, the Act's structure, and the historical context in which it was enacted establish that Congress intended to require that interconnection and network element rates be based on the historical costs that are recorded in the LECs' ratemaking books. They claim that "cost" means the "amount paid" for the facility in question (LEC Br. 19), that prior ratemaking orders establish that the LECs' expenditures are prudent (*id.* at 47), and that Congress intended the term "'cost' [to] refer[] to something already established and readily available," *i.e.*, the LECs' "historical cost as documented on [their] books." *Id.* at 22.

There is no basis for these contentions. If anything, the Act forecloses the method the LECs propose. In all events, the FCC's rejection of their proposal was a reasonable interpretation of the Act and is entitled to deference. *Chevron, U.S.A., Inc.* v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837, 843-45 (1984).

1. First, there is no substance to the LECs' contention that the plain meaning of the term "cost" is the "entire amount paid" for an asset. LEC Br. 19 (citing *Black's Law Dictionary* 345 (6th ed. 1990)). This dictionary now contains 30 different definitions of "cost," and these include forward-

looking replacement cost: that is, "[t]he cost of acquiring an asset that is as equally useful or productive as an asset currently held." *Black's Law Dictionary* 349-50 (7th ed. 1999). This Court has thus held that "cost" is a term that has "no technical meaning," that "connotes the use of judgment," and that it permits both historical and forward-looking approaches. *National Ass'n of Greeting Card Publishers* v. *United States Postal Serv.*, 462 U.S. 810, 832 (1983).

These principles have special force in the context of the Communications Act in general and of § 252(d)(1) in particular. Where Congress wished to permit or require the use of "original" or historical cost for a regulatory purpose under the Communications Act, it said so expressly. See 47 U.S.C. § 213(b)-(d). Moreover, in § 252(d)(1), the term "cost" is used in a context which manifestly does not compel – and, if anything, forecloses – the LECs' proposed construction.

The LECs' claim is that § 252(d)(1) requires that rates be based on the "historical cost" of purchasing the facilities that comprise the network element or interconnection in question. But that is not what § 252(d)(1) says. It requires that rates be based on the "cost" of "providing" the facility. The cost of "providing" an interconnection or network element is manifestly not what was paid for the relevant facilities in the past, for that amount is "sunk" and unavoidable.[16]

2. The LECs also claim that § 252(d)(1) has to be construed to require a historical-cost method because that was

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[16] *See* AT&T Pet'rs' Br. 21-37; *see also* A. Kahn & W. Shew, *Current Issues In Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191, 225 (1987); C. Horngren et al., *Cost Accounting: A Managerial Emphasis* 378, 396 (10th ed. 2000) (defining "relevant costs" as "those *expected future costs* . . . that differ among the alternative courses of action being considered," and "especially emphasiz[ing] the idea that all past costs and, in particular, book value (original cost minus accumulated appreciation) of the existing equipment, are irrelevant" (second emphasis omitted)).

the prevailing method of determining costs of service and of setting "just and reasonable" rates at the time the 1996 Act was passed. This claim is wrong, both legally and factually. First, this Court has held that when Congress uses the term "cost" without further specification, it has authorized the ratemaking agency to reject "'fully allocated'" costs or other historical-cost methods, even if they had represented the ratemaking and "accounting methods current at the time the bill was enacted." *National Ass'n of Greeting Card Publishers*, 462 U.S. at 817 & n.3, 831.

Second, the LECs' claim rests on a false factual premise. Historical cost was not the current method when the 1996 Act was passed. To the contrary, the FCC and most states had by then abandoned historical-cost ratemaking even for the purpose of regulating the LECs' overall revenues and earnings. The FCC found that this method gave the LECs incentives to be inefficient and that regulators simply could not administer this ratemaking method in ways that would prevent excessive rates. See *supra* pp. 3-6. Beyond that, even when historical-cost ratemaking had been previously used to establish maximum overall revenues and earnings, the FCC and states had rejected this ratemaking method where, as here, the issue is the individual rates that LECs should charge their competitors for access to essential facilities. These rates had long been set under TSLRIC and other forward-looking replacement cost methods. AT&T Pet'rs' Br. 6-12.

Congress was fully aware of the adverse effects of historical-cost ratemaking. Both the House and Senate had passed bills banning the use of such rate-of-return regulation to establish LECs' maximum earnings. See Order, ¶ 704 (JA 397-98). Although these prohibitions were deleted by the Conference Committee from the 1996 Act, it is preposterous to claim that Congress intended simultaneously to require that network-element and interconnection rates be set under this method.

Beyond that, the language that was not deleted from the 1996 Act squarely bars the LECs' claim (LEC Br. 22, 47) that amounts recorded in the LECs' ratemaking books must be deemed to be reasonable estimates of cost. The LECs base this claim on their assertions that prior state and federal ratemaking proceedings established the "prudence" of these costs. But the parenthetical terms of § 252(d)(1)(A)(i) expressly foreclose any such claim. That section mandates that the cost of providing the element be "determined without reference to a rate-of-return or other rate-based proceeding." 47 U.S.C. § 252(d)(1)(A)(i). Thus, although the LECs are correct that one purpose of the Act is to allow interconnection agreements to be adopted swiftly, § 252(d)(1)(A) prohibits tribunals from doing so by treating prior rate-of-return ratemaking proceedings as establishing that "readily available" entries on the LECs' ratemaking books represent the costs of providing a network element or interconnection. Compare LEC Br. 22.[17]

The LECs' claims are also foreclosed by the fact that § 252(d)(1) specifies a method for setting rates that are "just and reasonable." 47 U.S.C. § 252(d)(1). The Court has held that the "just and reasonable" standard authorizes ratemaking tribunals to adopt any ratemaking method that produces permissible end results. See *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 602 (1944); *Wisconsin* v. *FPC*, 373 U.S. 294, 309 (1963). In particular, the Court has rejected claims that this standard requires historical-cost methods and has held

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[17] The LECs rely (LEC Br. 22) on the FCC's statement that this parenthetical phrase does not "further define the type of costs that may be considered, but rather specifies a type of proceeding that may not be employed to determine the cost of interconnection and unbundled network elements." Order, ¶ 704 (JA 397). But whether or not § 252(d)(1)(A) would bar prudent-investment ratemaking and the consideration of certain costs, it bars any claim that prior ratemaking proceedings establish that entries on LEC books represent actual costs of providing network elements.

that it authorizes forward-looking replacement cost methods. *Mobil Oil Exploration & Producing S.E., Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 224-25 (1991).

3. The LECs also erroneously claim that there are other provisions of the Act that establish that § 252(d)(1)(A) requires the use of historical-cost ratemaking and prohibits forward-looking methods. Their principal contention is based on § 252(d)(1)(B), which provides that network element and interconnection rates "may include a reasonable profit." 47 U.S.C. § 252(d)(1)(B). The LECs contend that unless historical-cost ratemaking is used, the "entire" subsection that addresses "profit" would be "irrelevant." LEC Br. 20-21. This claim is nonsense. There simply is no relevant difference between historical-cost and forward-looking methods for purposes of affording a "profit" to a regulated utility.

Under both historical and forward-looking cost methods, the utility is to receive revenues that recover the sum of its (1) reasonable operating expenses and taxes; (2) the allowed depreciation on its investment; and (3) a prescribed rate-of-return multiplied by the current value of the utility's investment. See generally S. Breyer, *Regulation and Its Reform* 36-37, 40-41 (1982). Under both methods, the object of the rate-of-return on investment component is to allow the utility to earn a "reasonable profit" – that is, to earn revenues in excess of reasonable expenditures – and to pay dividends to the utility's shareholders. *Id.*[18] Under both methods, the profit is to reflect the risk of operating under the regulatory regime. See *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 310, 315 (1989).

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[18] The "return on investment" component is generally comprised of two elements: the cost of servicing the utility's debt (*i.e.*, paying interest on bonds) and return on equity (*i.e.*, the earning and profits from which dividends are paid). S. Breyer, *Regulation and Its Reform* 40-41 (1982); C. Phillips, Jr., *The Regulation of Public Utilities* 388 (1993).

For present purposes, the only difference between historical-cost and forward-looking methods is the way in which they calculate the magnitude of the "reasonable profit" that the regulated firm will be allowed to earn. Historical-cost methods value the investment to which the rate-of-return is applied based on the original cost of the plant, less amounts found to be imprudent and less depreciation. By contrast, TELRIC values the investment based on the current efficient costs of establishing facilities that provide the same functions as the LEC network. Each method can arrive at a value of the LECs' gross investment that is less than the LECs' "actual" past expenditures. Each can thus also be conceived of as having "written off" some fraction of that investment – just as LECs and other corporations routinely write off some of their investments for financial accounting purposes and report earnings and profits to shareholders on this basis in SEC and other filings. See AT&T Pet'rs' Br. 4.

The basis for the LECs' current claim is that the return on investment component of the rate formula is referred to in the FCC's Order (as it is in many contexts) as representing the "cost of capital" – that is, the earnings that a utility must receive to be able to attract debt and equity capital investments. Return on investment can thus be conceived of as a cost of providing a network element or interconnection within the meaning of § 252(d)(1)(A) – such that no separate determination is required under § 252(d)(1)(B). LEC Br. 21. But the use of the term "cost of capital" is equally apt under a historical-cost method. See *Hope Natural Gas Co.*, 320 U.S. at 603. So notions of "profit" can be "embodied" in a "definition of cost" under historical-cost methods as well. LEC Br. 21. Thus, if the LECs' claim were valid, the Act would foreclose both historical-cost and forward-looking methods. But the claim is clearly not valid. Whether a ratemaking body uses the term "return on investment" or

"cost of capital," it is exercising discretion to allow the LEC an opportunity to earn a "reasonable profit."[19]

4. Finally, the LECs' claims are barred by an independent requirement of § 252(d)(1)(A) that they simply ignore. The Act mandates not only that network element and interconnection rates be based on costs, 47 U.S.C. § 252(d)(1)(A)(i), but also that the rates be "nondiscriminatory." *Id.* § 252(d)(1)(A)(ii); *accord id.* § 251(c)(2), (3). Congress adopted this separate requirement to make it explicit that LECs cannot provide interconnections and network elements to competitors at economic costs that are higher than the LECs themselves incur when they use the same facilities to provide their own competing services. Order, ¶¶ 217-218, 859-862 (JA 277-78, 434-36). The LECs cannot and do not challenge the FCC's finding that TELRIC represents the economic costs that LECs incur when they use network elements in their retail services and that it would be discriminatory if LECs could impose higher costs on competitors. *Id.* Thus, § 252(d)(1)(A)(ii) independently forecloses the LECs' claim that they have a statutory right to base network element rates on historical costs whenever historical costs are higher than rates set under TELRIC.

For all the foregoing reasons, the Act should, if anything, be held to foreclose historical-cost ratemaking. But to reject the LECs' interpretive claims, the Court need only hold that the "general terms" of § 252(d)(1) convey "broad methodological leeway" and "say little about the 'method

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[19] The LECs also have made claims (LEC Br. 22-23) based on the separate standard that § 252(d)(2) adopts for setting rates for the "wholesale services for resale" authorized by § 251(c)(4). Because this is a separate statutory provision, it would be besides the point even if it did guarantee the LECs recovery of their "historical costs." But it does not. To the contrary, the provision allows new entrants to obtain services that are offered at retail below their costs and that are subsidized by other services (such as exchange access) and universal service payments under section 254 of the Act. Order, ¶¶ 875, 907-908 (JA 436-37, 437-38).

employed' to determine a particular rate." *AT&T Corp.* v. *Iowa Utils. Bd.*, 525 U.S. 366, 423 (1999) (Breyer, J., concurring in part and dissenting in part).

II. THE TAKINGS CLAUSE DOES NOT REQUIRE THE 1996 ACT TO BE INTERPRETED TO MANDATE HISTORICAL-COST RATEMAKING.

The LECs alternatively argue that the Takings Clause of the Fifth Amendment required the FCC to reject TELRIC and to adopt a method that guarantees that LECs will recover all their historical costs in their rates for network elements and interconnections. The LECs here concede – as they must – that the Eighth Circuit correctly held that they have not shown that the FCC's adoption of a forward-looking method has resulted or will result in an uncompensated taking of their property and that any takings claim is not ripe for review and premature. LEC Br. 37.

However, the LECs contend that they do not have to prove an actual uncompensated taking to invalidate forward-looking pricing. Although § 252(d)(1) does not compel a historical-cost method, they claim that such a method would nonetheless have represented a permissible interpretation of the statutory terms and that historical-cost ratemaking would raise no constitutional issues. By contrast, they contend that the rates that are set under the FCC's forward-looking approach will give rise to "serious constitutional questions" under the Takings Clause and that the FCC was required to adopt an historical-cost interpretation to avoid any constitutional doubts. LEC Br. 37.

The short answer to this claim is that "historical cost" is not a permissible interpretation of § 252(d)(1)(A)(i). Even if "cost" could be construed to mean "historical" cost – which is doubtful – the LECs cannot and have not disputed that including all historical cost in network element and interconnection rates would violate the separate

"nondiscrimination" requirements of § 252(d)(1)(A)(ii) and § 251(c)(2), (3). See *supra* p. 23.

In all events, the LECs' claims are otherwise meritless. "The 'constitutional doubts' argument has been the last refuge of many an interpretive lost cause." *Reno* v. *Flores*, 507 U.S. 292, 314 n.9 (1993). "Statutes should be interpreted to avoid *serious* constitutional doubts, not to eliminate all possible contentions that the statute *might* be unconstitutional." *Id.* (citation omitted). And when agency regulations are challenged on the ground that they may be implemented in ways that could give rise to future takings claims, the acceptance of these interpretative contentions can "merely frustrate[] permissible applications of a statute or regulation." *United States* v. *Riverside Bayview Homes, Inc.*, 474 U.S. 121, 128 (1985). The Court has thus held that it will not invalidate an agency's implementing regulation unless there is a "substantial argument" that "there is an identifiable class of cases in which application of a statute will necessarily constitute a taking." *Id.* at 128 n.5; see *United States* v. *Security Indus. Bank*, 459 U.S. 70, 75-76 (1982).

The LECs cannot make this showing. Even if the FCC were here regulating the LECs' overall regulated revenues, this Court's holdings establish that historical cost and forward-looking replacement cost are each permissible methodologies, and the FCC's adoption of a forward-looking method is no more likely to produce "end results" that give rise to takings claims than is a historical-cost method. Accordingly, the LECs' claims that TELRIC will necessarily produce unconstitutional results are not based on the terms of the regulation. Rather, they rest on a series of extrarecord factual assertions about the future effects of the regulation that are procedurally improper, factually unsupported, and erroneous.

A. Even If TELRIC Required That Network Elements And Interconnections Be Provided Below Historical Cost, The LECs Have Presented No Serious Takings Claim.

Preliminarily, the adoption of TELRIC would raise no federal constitutional question even if there were substantial claims that TELRIC would result in rates for network elements and interconnections that exclude costs that LECs incur in providing them and that the LECs are entitled to recover. If that were to occur, the FCC has made it clear that the LECs are entitled to seek to recover that shortfall through other FCC-regulated charges. Under this Court's holdings, this remedy precludes any claim that the adoption of TELRIC itself presents a serious risk of an uncompensated taking.

First, contrary to the LECs' suggestions, even if it were certain that TELRIC rates would be below cost, that would not itself establish an uncompensated taking. In *B&O Railroad* v. *United States*, 345 U.S. 146 (1953), the Court dismissed a takings claim that rested only on the allegation that a railroad had been required to ship a particular commodity at a rate below its costs. The Court held that "so long as rates as a whole afford railroads just compensation for their over-all services to the public the Due Process Clause should not be construed as a bar to the fixing of noncompensatory rates for carrying some commodities." *Id.* at 150. Similarly, in *Duquesne Light Co.* v. *Barasch*, the Court held that it was irrelevant that the utility had been denied any compensation for its prudent investment in a cancelled plant, for the utility's overall revenue from all its regulated operations was sufficient to allow it to attract capital. 488 U.S. 299, 310-12 (1989).

Second, the FCC's Order provides that in the event network element rates do not cover all the costs that LECs are entitled to recover, they can seek to make up the difference through other FCC-authorized charges. In particular, before the FCC, the LECs had claimed that they are threatened with a future

shortfall because they formerly were required to depreciate their equipment over artificially long periods of time and that they had substantial "depreciation reserve deficiencies" which could not be recovered in network element rates under TELRIC. In actual fact, subsequent events have eliminated any deficiencies, and the FCC recently found that LECs now have substantial depreciation reserve surpluses.[20]

However, the decisive fact for present purposes is that the FCC's TELRIC Order did not hold that the LECs are to be barred from recovering any depreciation reserve or other shortfall. It merely concluded – consistent with the testimony of the LECs' economic experts (see AT&T Pet'rs' Br. 16-17) – that including these amounts in network element and interconnection rates is not the proper remedy for underdepreciated assets, for artificially inflating these charges will distort local competition. Order, ¶ 706 (JA 399-400). The FCC thus provided that after TELRIC is implemented, the LECs will be free to come to the FCC and demonstrate that there was an unrecovered depreciation deficiency or some other shortfall. The FCC would then consider authorizing the recovery of these amounts in universal service surcharges or in other rates within its jurisdiction. *Id.* ¶¶ 706-707 (JA 399-401).[21]

No LEC has attempted to show that it in fact has a shortfall in its rates due to a depreciation reserve deficiency or otherwise. The LECs' claim to this Court rests on the ground that, if a LEC were to make such a showing, the FCC might fail to take the corrective action that would prevent an uncompensated taking of the LEC's property.

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[20] *Federal-State Joint Bd. on Universal Serv.*, 14 FCC Rcd. 20156, 20345 (¶ 427) (1999).

[21] The LECs complain that it has not yet done so. LEC Br. 11-12, 36 n.15. But whether there are residual unrecovered historical costs can only be determined after state commissions set TELRIC-based rates.

However, under settled law, these facts do not state a substantial claim that the adoption of TELRIC will necessarily result in a taking of LEC property. If an uncompensated taking were to occur, it would be a consequence not of the adoption of TELRIC, but of the FCC's failure to enter an appropriate order in a future proceeding in which the LEC demonstrated a shortfall. This Court has held that where, as here, an agency's regulation rests on a reasonable interpretation of the underlying statute and is otherwise facially valid, it cannot be invalidated based on speculation that the agency would effect an uncompensated taking in a future proceeding. *Riverside Bayview Homes, Inc.*, 474 U.S. at 128.

Even more pertinently, there have been two prior cases in which federal agencies adopted new ratemaking methods and in which the utility's remedy in the event of a claimed shortfall was to seek relief before the agency. In each case, the Court rejected the same claim that the LECs make here: that the new regulatory regime was unlawful because it failed to adopt mechanisms to guarantee utilities the recovery of any shortfall. *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 392-93 (1974); *Permian Basin Area Rate Cases*, 390 U.S. 747, 770-71 (1968).

The LECs have attempted to avoid these holdings by advancing another claim. They contend that, under the Takings Clause, the FCC cannot rely on revenues from other services or explicit subsidy payments to make up for any shortfalls that may result from the LECs' provision of unbundled network elements. In their view, the teaching of *Brooks-Scanlon Co.* v. *Railroad Comm'n*, 251 U.S. 396, 399 (1920), is that in assessing the total effect of the order of a regulatory agency, the inquiry must be limited to the "segment" of the business whose "revenues" the agency "has control over and is responsible for generating." LEC Br. 33, 34 (emphasis omitted). It follows, the LECs claim, that the Takings Clause required the FCC to assure that the LECs'

"UNE business" will "generate a sufficient return to stand on its own." *Id.* at 35.

But UNEs are not the only revenues that the FCC regulates, so this latter claim would be erroneous even if the LECs' reading of *Brooks-Scanlon* were sustainable.[22] The FCC not only has jurisdiction over the pricing standards for network elements, but also over LEC interstate exchange access and other interstate charges that generate over 25% of their $112 billion in annual revenues.[23] Further, the LECs are now earning returns on their interstate investment of between 17.5% and 20.8%.[24] There is no basis for any claim that LEC revenues from interstate services could not make up for any shortfall resulting from the LECs' provision of UNEs at TELRIC-based rates.

B. The Adoption Of TELRIC Would Raise No Substantial Takings Claim Even If The Method Governed The Determination Of All Of The LECs' Regulated Revenues.

The LECs' claim suffers from a far more fundamental defect. Even if TELRIC governed the determination of all of the LECs' regulated revenues, the fact that it does not guarantee a return that formally applies to all the LECs'

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[22] *Brooks-Scanlon*'s holding is only that an agency cannot require a firm to operate a regulated business (there, a railroad) at a loss and rely on unregulated revenues (there, from lumber yards and sawmills) to make up the difference.

[23] Federal Communication Comm'n, *Trends in Telephone Service*, Tables 16.2 and 16.4 (2000) ($29 billion in access and subscriber line charges), *available in* Press Release, Federal Communication Comm'n, FCC Releases Study on Telephone Trends (Dec. 21, 2000).

[24] The weighted average return of the price-cap carriers (LECs) for 2000 was 19.53%. Federal Communications Comm'n, *Interstate Rate of Return Summary*, *available at* http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/IAD/ror00.pdf.

historical costs and investment presents no issue under the Takings Clause.

The Takings Clause does not afford any firm a right to recover its historical costs. It requires that the government pay "just compensation" when "private property" is dedicated to a public use. U.S. Const. amend. V. It has been settled for a century that just compensation does not equal the "costs" incurred by an owner in acquiring or developing property.

As a general matter, just compensation is determined by the current value of the property measured by its fair market or rental value – ordinarily "what a willing buyer would pay in cash to a willing seller." *United States* v. *Miller*, 317 U.S. 369, 374 (1943). The current fair market value "may be more or less than the owner's investment. He may have acquired the property for less than its worth or he may have paid a speculative and exorbitant price." *Olson* v. *United States*, 292 U.S. 246, 255 (1934). But "the Fifth Amendment allows the owner only the fair market value of his property; it does not guarantee him a return of his investment." *United States ex rel. TVA* v. *Powelson*, 319 U.S. 266, 285 (1943). Just compensation under the Takings Clause is thus forward-looking, not backward looking.

These same rules apply to regulated monopolies. In *Smyth* v. *Ames*, 169 U.S. 466 (1898), the Court rejected a claim that a railroad was entitled to rates that would fully compensate it for its historical investment in property dedicated to public use. *Id.* at 543. It held that this property must be valued – like ordinary property taken for public use – based on the current "fair value" of utility property rather than its historical cost. *Id.* at 546-47. Recognizing that in most circumstances there is no ready market for such property and hence no established fair market value, *Smyth* required courts to determine value by considering a variety of types of evidence – including the "original cost of construction" and the "present" cost of reproducing the plant – and to compute the

depreciation and return on investment components of rates based on this valuation. *Id.* at 547.

In *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), the Court abandoned the rule of *Smyth* v. *Ames* as a constitutional requirement, stating that, strictly speaking, "'fair value' is the end product of the process of rate-making not the starting point." *Id.* at 601. *Hope* thus upheld rates that had been set under a historical-cost method, but expressly declined to adopt prudent investment as a constitutional requirement or to prohibit use of forward-looking replacement cost methods. It stated that a rate order is constitutional if its "end result" is to provide the opportunity for a return on investment "commensurate with returns on investments in other enterprises having corresponding risks." *Id.* at 603. The Court held that the choice of ratemaking methodology itself raises no constitutional issue. *Id.*

Since *Hope* was decided, this Court has repeatedly rejected claims that utilities are entitled to recover their "prudent investments" and that the use of a "fair market value" method is impermissible. In *Market Street Railway* v. *Railroad Commission*, 324 U.S. 548, 564-65, 569 (1945), the Court upheld a rate order that limited the carrier's compensation to the fair market value of its assets, which (due to declining demand) were less than a third of its historical costs and were also less than the estimates of replacement costs. The Court has similarly rejected claims that a regulated firm has a right to have its rates "'base[d] . . . on [its] own [historic] costs.'" *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508, 517 (1979).

More recently, in *Duquesne*, the Court upheld a decision of the Pennsylvania Supreme Court which (based on an intervening change in state law) had revised a rate order so that it denied the utility any return on certain investments that had been prudent when made, but that were no longer "used and useful." 488 U.S. at 312 n.7. The Court noted that Pennsylvania had thereby adopted elements of fair value ratemaking, which attempts more closely to "mimic[]" a

competitive market. *Id.* at 308, 315. The Court again rejected the claims that prudent historical investment should be adopted as the constitutionally required ratemaking methodology because, among other things, such a rule would "unnecessarily foreclose alternatives which could benefit both consumers and investors" – such as "a return to some form of the fair value rule just as its practical problems may be diminishing." *Id.* at 316 & n.10.

The Court thus held that a rate order will be confiscatory only if the "rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital." *Id.* at 312. In this regard, the Court noted that the "impact of certain rates can only be evaluated in the context of the system under which they are imposed," for "[t]he risks a utility faces are in large part defined by the rate methodology." *Id.* at 314-15. And it reaffirmed that the method adopted to value the utilities' investment presents no constitutional issue, for errors in valuation "may well be canceled out by countervailing errors or allowances in another part of the rate proceeding": *e.g.* by the authorized rates of return and depreciation. *Id.* at 314; see *id.* at 317 (Scalia, J., concurring) (no substantial takings questions are presented in a case that "challenges techniques rather than consequences"). Since *Duquesne*, this Court has upheld rate orders that used forward-looking replacement cost methods to set "just and reasonable" rates. *Mobil Oil Exploration & Producing S.E., Inc.* v. *United Distribution Cos.*, 498 U.S. 211, 224 (1991).

In short, under this Court's decisions, the adoption of a forward-looking replacement cost method itself raises no constitutional issues under the Taking Clause, and a subsequent rate order is valid so long as it allows returns on investment that reflect the risks of operating under that regime. TELRIC's terms expressly require such returns. As the FCC made explicit, TELRIC requires that depreciation and rate-of-return calculations reflect all the risks of operating

in an environment in which rates are based on the costs of efficiently replacing the particular network element at issue. Order, ¶ 687 (JA 385). On its face, TELRIC is thus a perfectly reasonable and valid method that requires consideration of all the relevant factors, and it palpably will not "necessarily" lead to uncompensated takings of property in any "identifiable class of cases." *Riverside Bayview Homes, Inc.*, 474 U.S. at 128 & n.5. Further, before the FCC, the LECs did not introduce any evidence that the necessary or even likely effect of the adoption of TELRIC could possibly be to jeopardize the "financial integrity" of their companies or of even any segment of them. Compare Order, ¶¶ 738-739 (JA 421-22), with *Duquesne*, 488 U.S. at 312.

Finally, the reason that the validity of rate orders depends entirely on their "end result" is that any ratemaking method can be applied in ways that either do or do not allow the utility to earn an appropriate risk-adjusted return on investment. Accordingly, forward-looking methodologies like TELRIC are no more likely to result in meritorious taking claims than are historical prudent-investment or other ratemaking methods.[25]

C. The LECs' Claims Of A "Switch" In Methodologies Are Legally Meritless And Depend On Erroneous Extrarecord Assertions.

The consideration of the LECs' taking-based claims can thus begin and end with the fact that there is no basis for a claim that TELRIC would result in rates that are confiscatory even if LECs' only business were the provision of network elements.

However, the LECs also make two related claims that purport to be based on the Takings Clause. Each rests on

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[25] Indeed, there have been many recent cases in which utilities raised taking claims under prudent-investment regimes. *See infra* p. 44 nn.31-32.

assertions that the adoption of TELRIC represents a "switch" in ratemaking methodologies that will deny LECs the recovery of substantial costs that they putatively had a right to recover under the historical prudent cost method that purportedly governed their operations before TELRIC was adopted. First, the LECs rely on *Duquesne*'s statement that it would "raise serious constitutional questions" if an agency were "to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." 488 U.S. at 315. Second, the LECs' claim that the adoption of TELRIC breached a "regulatory compact" in which LECs made their network investments in exchange for a guarantee that they always would recover all of their historical investments.

These claims are legally baseless. Further, they rest on the LECs' extrarecord assertions that TELRIC has been, or might be, applied in particular ways. But these claims are out of order in an appeal from the "final agency action" that adopted TELRIC. Compare LEC Br. 37. In addition, the claims do not rest on competent evidence, and are demonstrably erroneous.

The basic fallacy of both LEC claims is that TELRIC simply does not represent a "switch" in ratemaking methodologies. The FCC's adoption of TELRIC to set interconnection and network elements rates has no effect on the ratemaking methods that govern the interstate and intrastate telecommunications services that LECs have historically provided. These services continue to be subject to the ratemaking methods that were in effect before the 1996 Act was adopted and implemented. For the same reasons, TELRIC does not "rewrit[e] the terms of thousands of regulatory transactions [long] closed" (*id.* at 30), and the rhetoric of "harsh retroactivity" and a regulatory "bait and switch" that pervades the LECs' Brief is simply inapt. *Id.* at 29, 30. That is particularly so because it has been the case for

more than a decade that the LECs have been subject to a price cap regime in which they did not have any right to a return on all historical prudent investment.

Rather than change the regulatory treatment of the LECs' existing interstate and intrastate telephone services, the FCC adopted TELRIC to govern the pricing of new wholesale arrangements – interconnections and network elements – that LECs were required to provide for the first time by virtue of the 1996 amendments to the Communications Act. By adopting TELRIC for this purpose, the FCC was following the same ratemaking method that governed the setting of rates for other essential facilities that LECs provide to their competitors. And while the new arrangements allow new entrants to offer local services that compete with those of the LECs, in the nearly five years since TELRIC was adopted, fewer than 3% of the nation's telephone lines have switched to firms that use unbundled network elements to offer competing services.[26]

1. TELRIC Is Not An Impermissible Switch In Methodologies That "Strands" Investment.

The "serious constitutional questions" that *Duquesne* identified arise only if an agency arbitrarily switches ratemaking methods back and forth "in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others." *Duquesne*, 488 U.S. at 315. Here, there has been no switching of methods, much less switching back and forth. And the effect of the adoption of TELRIC was neither to require investors to bear the risk of bad investment nor to deny them the benefit of good ones. In short, the LECs

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[26] Press Release, Federal Communications Comm'n, FCC Releases Latest Data on Local Telephone Competition (May 21, 2000) (new entrants serve 8.5% of lines, about one third of them using unbundled network elements).

simply have not made the showing that would, in *Duquesne*'s words, "raise serious constitutional questions." *Id.*

The LECs are thus reduced to contending that *Duquesne* adopted another very different rule, *sub silentio*. Specifically, they contend that, under *Duquesne*, a tribunal cannot lawfully adopt a forward-looking method unless it demonstrates that it will permit a utility to achieve rates that fall with the same range as would result from the operation of an historical prudent-investment method. LEC Br. 27. The LECs claim that the adoption of TELRIC violates this rule because it allegedly was "designed" to produce network valuations that are 50%-60% lower than those that would be produced under a historical-cost method. LEC Br. 40. In their view, it follows that TELRIC will unlawfully "strand" the LECs' prudent investment. These claims have no basis even apart from the LECs' misplaced reliance on the concept of "stranded investment."[27]

Duquesne did not adopt a rule under which regulatory agencies could depart from historical-cost methods only if they showed that the departure would have no substantial

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[27] "Stranded" investment refers to "investments in specialized, durable assets that may have seemed necessary, or at least justifiable, when constructed and placed into service under a regime of price and entry controls but that have become underutilized or even useless under deregulation," such as an electric generation plant that is idled by an agency order requiring transmission of competitively generated power. H. Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L. J. 801, 802-03 (1999) (book review). Stranding would only occur under the Act if the LECs' network facilities became underutilized because competitors constructed and used alternative facilities. By contrast, when competitors provide service over leased network elements, no stranding occurs. *See* W. Baumol & T. Merrill, *Does The Constitution Require That We Kill The Competitive Goose? Pricing Local Phone Service To Rivals*, 73 N.Y.U. L. Rev. 1122, 1143 (1998). Because the sole issue here relates to the rates LECs receive when they lease out their facilities, the LECs reliance on the FERC's stranded-cost orders is wholly misplaced, LEC Br. 12 n.8.

effect on the resulting rate levels. The object of all ratemaking is to foster efficiency and to prevent rates that recover inefficient or wasteful expenditures. The Federal Constitution could not preclude the adoption of a ratemaking method merely because it is more effective in carrying out these objects than the prudent-investment method (which the FCC previously determined to foster inefficiencies that regulators are incapable of preventing).

The LECs are simply wrong in arguing that *Duquesne* held otherwise. Their contentions rest only on the Court's statement that the utility had not claimed that the "total effect" of the revised rate order was unconstitutional, for this order differed in only *de minimis* ways from the prior order that the utility was seeking to reinstate. *Duquesne*, 488 U.S. at 311-12. That was a description of the two orders, not a statement of constitutional requirements.

Contrary to the LECs' misstatement (LEC Br. 9, 40), the FCC did not "adopt[] TELRIC with the *express purpose* of producing prices lower than historical costs." Rather, the FCC determined that the competitive goals of the Act demanded pricing based on economic costs, "which may be higher or lower than historical embedded costs." Order, ¶ 705 (JA 399). And, there is palpably no basis for the LECs' claim that the FCC adopted TELRIC because it was designed to value the LECs' networks at levels 50-60% lower than would a prudent historical-cost method. As explained above (*supra* pp. 8-13), these claims rest on extrarecord assertions that are unsupported, that rest on apples-to-oranges comparisons, and that are inconsistent with the very data sources upon which the LECs rely.

But even if the overall network valuations were certain to be lower under TELRIC, that would only raise the question of why this difference exists. If it were the product of facts that would have foreclosed the LECs' recovery of the difference under strict applications of a prudent-investment methodology, the difference obviously would have no

constitutional or other significance. For example, any prudent-investment regulator would exclude from the rate base the substantial amount of phantom assets that appear on the LECs' books, but that are not in use in the LECs' networks. *Continuing Prop. Records Audit*, 14 FCC Rcd. 7019, 7019 (¶ 1) (1999). It should similarly exclude the vast amounts of excess capacity the LECs have installed to provide unregulated enhanced services in the future. In this regard, a major reason that AT&T and others advocated TELRIC is that it is a very efficient way of determining how the LEC networks should be sized to meet existing demand and of preventing LECs from recovering from competitors the costs of present excess capacity that was installed to support the LECs' future competitive services.

Finally, even if TELRIC were certain to produce lower asset values and thus a lower "rate base" than would other ratemaking methods, the "end result" could still be the same. The effects of a lower TELRIC rate base "may well be cancelled out by countervailing errors or allowances in another part of the rate proceeding." *Duquesne*, 488 U.S. at 314. Indeed, the favorable effects of depreciation[28] or cost-of-capital[29] allowances may offset any effect of the different

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[28] TELRIC permits economic depreciation that reflects expected price declines and the risk of obsolescence associated with technological change, Order, ¶ 686 (JA 384-85). That would result in higher depreciation allowances than the LECs receive under historical-cost methods, particularly if it were true (*compare* LEC Br. 4) that regulators require artificially prolonged useful lives.

[29] In *Duquesne Light Co.* v. *Barasch*, the Court held that the regulators' exclusion of certain prudent investments from a utility's rate base raised no constitutional issue, for the utility had received a rate-of-return higher than the minimum that would have been required under a prudent-investment method. 488 U.S. 299, 312 (1989). In making its determinations under TELRIC, the FCC currently uses a rate-of-return of 11.25%, which was established in 1990. *See supra* p. 5 n.1. That was an exceedingly generous rate-of-return even at that time, and because interest

methods for valuing the rate base. Thus, the "end result" could be the same under either method.

2. The LECs' Regulatory Compact Claim Is Meritless.

There is similarly no foundation for the LECs' suggestion that the adoption of TELRIC violated a regulatory compact in which they built local networks in exchange for a promise that they could recover their historical costs in rates. The LECs assert – without citation of authority – that under any constitutional ratemaking regime "investors expectations are settled by a predictable mechanism that informs investors in advance how they will be paid." LEC Br. 24. But that assertion is squarely foreclosed by *Duquesne*, which upheld a revised rate order that excluded $35 million of investment that was recoverable under the prior ratemaking method. 488 U.S. at 312-14. And while regulatory compacts can exist, the LECs simply are not parties to one.

First, contracts specifying regulatory duties and entitlements were sometimes entered into during the nineteenth-century, usually in the form of corporate charters to internal improvement corporations or franchises for use of the public right-of-way. See R. Seavoy, *The Origins Of The American Business Corporation, 1784-1855*, at 39-51 (1982). However, this Court then held that the power to regulate rates existed independently of any compact to dedicate property to public use. See *Munn* v. *Illinois*, 94 U.S. 113, 125-26, 133 (1876); *accord Nebbia* v. *New York*, 291 U.S. 502, 536-39 (1934). And rate regulation was imposed on the LECs after they had made their investment, not as the quid pro quo in a regulatory compact. See H. Hovenkamp, *The Takings Clause and Improvident Regulatory Bargains*, 108 Yale L. J. 801, 804-05 (1999) (book review).

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rates and costs of equity are radically lower today, a much lower rate-of-return could now be applied under a prudent-investment regime.

Further, neither the state nor federal regulatory schemes ever guaranteed any LEC that it could recover all historical costs. To the contrary, the LECs expanded and maintained their networks subject to the very general standard that the rates must be "just and reasonable," which affords the agency considerable "pricing flexibility" to change methodologies as the public interest requires. *Mobil Oil Exploration & Producing S.E., Inc.*, 498 U.S. at 224. Under this regime, the LECs unilaterally decide which investments to make. To enforce the "just and reasonable" standard, regulators can review a LEC's investments long *after* they were made to decide whether they should be included, in whole or part, in the "rate base" under the policies that the regulatory body then chooses to apply. See Hovenkamp, *supra*, at 822.

Under these systems, it is well settled that even if a regulatory commission made an affirmative decision to include an investment in a rate case in one year, the commission may make a different determination in future years by either adopting a different policy or ratemaking standard or by applying its prior standard more rigorously. As this Court has held, "[t]he declaration of a specific policy creates no vested right in its maintenance in utilities then engaged in the business," *Tennessee Electric Power Co.* v. *TVA*, 306 U.S. 118, 141 (1939), and a court will not "set aside [a rate order] merely because the Commission has on an earlier occasion reached another result" under a different ratemaking standard. *Permian Basin Area Rate Cases*, 390 U.S. 747, 784 (1968).

The fact that the regulatory environment was structured to encourage LECs to invest in their network to promote universal service does not create a binding obligation to base rates on historical costs. Unless the government has by express terms of a contract committed itself to a particular regulatory course, it is not bound to compensate a regulated entity that claims to have relied on the prior scheme. See *United States* v. *Winstar Corp.*, 518 U.S. 839 (1996);

Louisville Bridge Co. v. *United States*, 242 U.S. 409, 420 (1917); J. Rossi, *The Irony of Deregulatory Takings*, 77 Tex. L. Rev. 297, 308-09 (1998) (book review). The LECs have no more right than any other entity to be compensated for the inability to recover all past investment due to regulatory change. Cf. *Keystone Bituminous Coal Ass'n* v. *DeBenedictis*, 480 U.S. 470, 495 (1987) (describing "regulatory takings").

III. THE FCC'S REJECTION OF THE LECS' HISTORICAL-COST PROPOSALS WAS NOT ARBITRARY AND CAPRICIOUS.

Finally, there is no substance to the LECs' claims that it was arbitrary and capricious for the FCC to reject historical-cost ratemaking and to adopt a forward-looking method. As this Court has held, the determination of the proper cost standard to use in setting rates is one of the "kind of basic judgments about economic policy" that is uniquely committed to the discretion of federal agencies and that courts are ill-suited to second-guess. *American Commercial Lines, Inc.* v. *Louisville & Nashville R.R.*, 392 U.S. 571, 590 (1968). Accordingly, to succeed on their claims, the LECs must show that the FCC failed "adequately [to] consider[] the factors relevant to choosing a rate that will best serve the purposes of the statute" and that it "committed a 'clear error of judgment'" in rejecting historical-cost ratemaking. *American Paper Inst., Inc.* v. *American Elec. Power Serv. Corp.*, 461 U.S. 402, 413 (1983). The LECs have not come close to satisfying this demanding standard.

Indeed, the reasonableness of the FCC's rejection of historical cost is established by the most elementary principles of economics and by the decade of regulatory and antitrust decisions that provided the background to the 1996 Act and that have been discussed throughout this brief.

First, the FCC and most states had determined that historical-cost ratemaking fosters inefficiencies that

regulators are incapable of controlling even in the very different context of regulating the LECs' overall revenues and earnings. The regulatory task in the performance of this function is merely determining the reasonable costs of a regulated firm as a whole and attempting to prevent it from earning monopoly profits. This function required no determinations of costs attributable to individual different facilities, functions, services, and locales. Nor did it present the regulated firm with incentives to misallocate costs among different facilities, functions, services, or areas to prevent or distort competition.

Second, the FCC and states had determined that historical-cost ratemaking methods are flatly inappropriate when the issue is establishing the conditions that will allow competition with retail services of the incumbent LEC. There is no truism more elementary in all of economics than that historical costs are irrelevant because they are "sunk" and "unavoidable,"[30] and that the relevant costs to decisionmaking in competitive markets are forward-looking costs. These are the "real" and "economic" costs that LECs incur when they use the essential facilities that they control to provide services at retail in competition with other firms. For that reason, these are the costs that the FCC and other regulatory bodies have long relied upon in determining the rates that LECs may charge prospective competitors for access to those essential facilities.

Against this background, to accept the LECs' claims that rates for network elements and interconnections should be based on historical cost, the FCC would have had to repudiate its own consistent prior decisions and the decisions of other regulatory bodies and antitrust authorities. AT&T Pet'rs' Br. 6-12. The notion that its failure to do so could have been arbitrary and capricious stands basic principles of

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[30] A. Kahn & W. Shew, *Current Issues In Telecommunications Regulation: Pricing*, 4 Yale J. on Reg. 191, 225 (1987).

administrative law on their head. And there is not the slightest substance to the claims that the LECs have made.

A. All Ratemaking Methods Are Hypothetical And There Is No Basis For The Claim That Other Methods Would Fulfill The Act's Objectives At Lower Administrative And Other Costs.

The LECs' primary claim is that it was arbitrary to reject their historical-cost proposals because the alternative forward-looking method is "hypothetical" and difficult to administer. These contentions are baseless.

1. As Professors Baumol, Willig, and Ordover testified before the FCC, "*[a]ll* cost-based ratemaking standards (including embedded cost ratemaking) involve hypothetical constructs." Baumol et al. Reply Aff. at 6 n.4 (JA 147). Prudent historical-investment and replacement-cost methods are both "hypothetical" for each seeks to foster efficiency by determining not what the utility is spending, but what it should be spending. The only difference is that one method makes hypothetical determinations by looking "forward" and the other by looking "backward."

TELRIC and other efficient replacement-cost methods determine the particular facilities that are required to meet the existing demand and what it would cost to construct and operate them from the "bottom up." It thus determines what an appropriately sized network should cost by looking forward.

Prudent historical-investment ratemaking makes the same determination on a backward-looking basis. It begins with the utility's existing assets and determines whether they should have been configured differently. But it does so by examining all of the historical decisions that caused the existing configurations to decide whether they are ones that "'reasonable utility management . . . would have made, in good faith, under the same circumstances, and at the relevant point in time.'" *New Orleans* v. *FERC*, 67 F.3d 947, 954

(D.C. Cir. 1995). As Judge Levanthal stated, "a conclusion of imprudence reflects a view of how business should be conducted." *TWA, Inc.* v. *CAB*, 385 F.2d 648, 656 (D.C. Cir. 1967).

In circumstances where costs were rising rapidly and commissions had strong incentives to determine if utilities had acted inefficiently in ways that harm the public, applications of the prudent-investment methodology have entailed extraordinarily detailed retrospective reviews of all the stages in a utility's internal decisionmaking processes over long periods of time. Based on these archeological expeditions, commissions have made assessments of the reasonableness of each incremental investment made during that period.[31] When imprudence is found, commissions then determine what costs the utility would have incurred in the hypothetical world in which it had been prudent. These inquiries entail such things as deciding what costs would have been if construction of a new plant had or had not been temporarily halted, abandoned or accelerated; if the utility had or had not sold off certain facilities and purchased substitutes; or if the utility had managed itself differently in myriad other respects.[32]

2. One reason that leading economists urged a forward-looking method is that there is evidence the existing LEC networks are inefficient, contain phantom assets, and were intentionally overbuilt with capacity that is not needed to meet existing demand, but that will be used only to provide unregulated enhanced and other new services in the future.

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[31] *See, e.g., Long Island Lighting Co.* v. *PSC*, 523 N.Y.S.2d 615 (N.Y. App. Div. 1987); *Kansas Gas & Elec. Co.* v. *State Corp. Comm'n*, 720 P.2d 1063 (Kan. 1986), *vacated in part*, 481 U.S. 1044 (1987); *Entergy Gulf States, Inc.* v. *Louisiana PSC*, 726 So.2d 870 (La. 1999).

[32] *See* cases cited in n.31. *See also, e.g., Consumers' Counsel* v. *FERC*, 914 F.2d 290, 296 (D.C. Cir. 1990); *Connecticut Light & Power Co.*, 43 FERC ¶ 63,029, at 65,228, 65,231 (1988).

See *supra* pp. 7-8. In this context, TELRIC and other forward-looking methods are the lowest cost methods of determining the efficient level of investment required to meet the existing demand, for they simply size and then cost a network from the "bottom up."

By contrast, the administrative and litigation costs of rigorously making these same determination under a backward-looking historical-cost method would be prohibitive. It would require penetrating the LECs' books and reviewing years of network planning decisions. The problems would have been radically compounded by the fact that the objective of the 1996 Act is not to determine the LECs' average statewide costs, but to determine the costs that LECs incur in providing services in discrete areas having different population densities and terrain. Order, ¶ 965 (JA 439). Because the LECs' historical costs are kept on state-wide or similar bases, this would have required allocations of book costs that would be complex and arbitrary. In short, the LECs have it exactly backwards in claiming that a prudent historical-cost approach would have helped in "speeding the transition to competition." LEC Br. 46. If rigorously applied in an attempt to foster the Act's procompetitive goals, a prudent-investment method would be slower, not speedier, and more expensive, not cheaper. Furthermore, as the FCC found, the end result of that process likely would have been rates that impede or foreclose competition, not rates that promote it. Order, ¶ 705 (JA 398-99).

3. The LECs' claims that forward-looking costing is administratively infeasible rest primarily on Justice Brandeis's 1923 opinion that criticized fair value ratemaking and summarized his reasons for then believing prudent-investment methods could achieve the same benefits at lesser costs. LEC Br. 45. But Justice Brandeis was addressing the determinations of the costs of service of an entire firm based on its books – where the sole object is to prevent the firm

from earning monopoly profits.[33] He was not addressing the matter of determining the cost of providing different facilities and functions in different locales – where the object is to assure that incumbent monopolists and their competitors obtain the same essential facilities at the same economic costs. Justice Brandeis also made his statements before there had been any experience with prudent-investment ratemaking, much less the experience that caused it to be rejected by the FCC and most states for the purpose for which Justice Brandeis had thought it to be well suited. This was also long before replacement cost pricing was not only proven eminently feasible, but also became commonplace, by the developments in computer modeling in more recent decades. Finally, Justice Brandeis manifestly did not argue that a commission should be required to use prudent investment if it determined based on experience that another method would be more effective for a different purpose.

The reality is that by 1996, forward-looking incremental costing approaches were the norm in this context. They had been successfully used for years by states in setting LEC prices for individual services and facilities, and the states had begun to apply long run incremental cost ("LRIC") methods to the pricing of network elements. See Order, ¶ 631 (JA 334-36). Indeed, they are such a staple of state regulatory oversight that LRIC cost studies are required by statute in many jurisdictions.[34] LRIC had been used by antitrust courts in resolving claims that Bell companies had engaged in predatory pricing by pricing individual services below their

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[33] Similarly, this was the subject matter of the FCC's 1992 Order that adopted historical-cost regulation to regulate retail cable television rates. *Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation*, 9 F.C.C.R. 4527 (1994).

[34] 220 Ill. Comp. Stat. 5/13-502(c); Mich. Comp. Laws Ann. § 484.2208(9); Minn. Stat. Ann. §§ 237.59, 237.772; Tex. Util. Code Ann. § 58.055(c); Utah Code Ann. § 54-8b-3.3(5); Wy. Stat. Ann. § 37-15-402(a).

relevant costs; by the Surface Transportation Board in pricing railroad services; and now has been adopted by the European Commission in opening its local markets to competition. See AT&T Pet'rs' Br. 8-12, 19-21, 32-33. The LECs also ignore that the FCC's thoughtful and well-supported predictive judgment has been proven correct – notwithstanding the LECs' claims of administrative unfeasibility, virtually all states have, in fact, managed to apply forward-looking pricing principles to estimate efficient replacement costs and establish network element and interconnection rates. See *id.* at 21 n.23.[35]

In light of this experience, the LECs grasp at straws in contending that the FCC did not provide adequate explanation of the administrability of TELRIC. Indeed, in addition to relying on the state regulatory experience, the FCC conducted "an initial examination" of various LRIC computer models that were submitted for the record, and concluded that "the remaining practical and empirical issues can be resolved in the near future." Order, ¶ 835 (JA 433).

Certainly, the FCC's expert determination of what methods are most cost effective is entitled to substantial deference, particularly where, as here, most of the LECs' complaints about administrability are simply anachronistic.

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[35] The LECs falsely claim that it took the FCC four years "of revising and updating various cost models" to "finally decide that TELRIC could be used to project costs accurately." Br. at 45. In fact, the FCC never wavered from its initial proposal that universal service costs, like network element and interconnection rates, should reflect forward-looking costs. And the proceedings to choose a particular cost model and inputs were completed in less than twenty-eight months, *Federal-State Joint Bd. on Universal Serv.*, 14 FCC Rcd. 20156, 20161 (¶ 5) (1999), notwithstanding the LECs' steadfast refusal to cooperate and provide customer location and other data within their sole control.

B. Competitive Pricing Of Network Elements Does Not Frustrate The Act's Purposes.

In the last two pages of their brief, the LECs make five cursory arguments that TELRIC is contrary to the Act. LEC Br. 48-49. One is a claim that they promise to elaborate on in their response brief to AT&T's and the FCC's appeal. AT&T will address that argument in its Petitioner's Reply Brief. The other four arguments can be summarily dismissed.

First, relying on an out-of-context statement from Justice Breyer's separate opinion in *AT&T Corp.* v. *Iowa Utilities Board*, 525 U.S. 366, 424 (1999), the LECs claim that the adoption of TELRIC short-circuits the "process" of competition and seeks to mandate a set of retail prices that would represent the "'end result'" of competition. LEC Br. 48 (emphasis omitted). But Justice Breyer addressed the initial FCC rules in which there was no "limit" on the facilities that could be leased as network elements under TELRIC. Under the FCC's current rules, the only facilities that can be leased from the LECs are those that competitors plainly need to offer competing services. As the FCC's findings establish, the availability of these facilities at TELRIC-based rates is thus necessary for competition to develop in the "unshared" parts of the network and to begin a "process" that will drive retail prices closer to competitive levels. Compare 525 U.S. at 430. By contrast, as the FCC found, if LECs could impose higher prices under a historical-cost method, the LECs could foreclose even the limited competition that has developed in the last five years. Order, ¶ 705 (JA 398-99).

Second, LECs claim that the FCC did not justify its assertions that historical costs would foster inefficient entry, and wonder how higher rates could induce inefficient competitors to enter the market. But the FCC's point, fully explained in the order, was that the entry – not the entrants – would be inefficient if prices did not reflect true economic costs. The FCC repeatedly pointed out that inflated network

element rates provide improper price signals and would cause investments in facilities that LECs can provide at a lower economic cost than any new entrant. See Order, ¶¶ 620, 635-636, 679, 708-711 (JA 327-28, 340-43, 379-80, 401-03).

Third, the LECs claim that the FCC ignored the threat to genuine competition from UNE prices that are too low. The LECs here simply repeat their unfounded claim that TELRIC does not represent the economic costs of providing the elements. If prices for essential inputs are set at economic costs, there is no underpricing. Moreover, given the high transactions costs of leasing network elements, new entrants still have ample inducement to engage in facilities-based competition, as AT&T is doing. See AT&T Pet'rs' Br. 14-15. In any event, Congress did not favor one entry strategy over another, Order ¶ 12 (JA 271-72), and efficiency in network element rates is not to be sacrificed based on projected and dubious effects on facilities-based competition.

Finally, the LECs renew their regulatory-compact arguments, now under the arbitrary-and-capricious banner, claiming that the opportunistic changing of regulatory rules will be a disincentive to future investment. But it is Congress that has set the rules of this game; the FCC has simply adopted methods consistent with those rules and suited for the new competitive environment. Moreover, TELRIC is structured to ensure a return on investment, see *supra* pp. 21-23, and it gives the same incentives to capital investment as exist in a competitive market.

CONCLUSION

For the reasons stated, the Eighth Circuit decision should be affirmed insofar as it upheld forward-looking pricing.

Respectfully submitted,

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